



MEMORANDUM

CSFRA, Community Development Department

DATE: August 24, 2020

TO: Rental Housing Committee

FROM: Karen M. Tiedemann, Special Counsel
Anky van Deursen, CSFRA Program Manager

SUBJECT: Draft Regulations Amending Chapter 6: Specified Capital Improvement Upward Adjustments

RECOMMENDATION

Review the draft regulations regarding Specified Capital Improvement Temporary Upward Adjustment Petitions and either (i) provide further direction to staff or (ii) adopt a resolution approving regulations.

BACKGROUND

Section 1710 of the CSFRA provides for petitions for individual rent adjustments including upward adjustments. Upward adjustments are to be granted only when a landlord demonstrates that the adjustments are necessary to maintain a fair rate of return. Section 1710(a)(2) and (a)(3) set out factors to be included in considering upward adjustment petitions, including the costs of capital improvements that are necessary to bring the property into compliance or maintain compliance with applicable local codes. The Rental Housing Committee ("RHC") in 2017 adopted regulations located in Chapter 6 defining a fair rate of return as the maintenance of the landlord's net operating income for the base year as adjusted by the Consumer Price Index.

The RHC has discussed options for adding an additional standard for upward adjustments to allow landlords to recover the cost of capital improvements in order to incentivize landlords to continue to maintain their properties and to comply with changing codes. The current fair return petition process considers capital improvements as one factor in determining net operating income and allows a landlord to receive an upward adjustment in rent if the property's adjusted net operating income decreases between the base year and the petition year. The current petition process requires landlords to provide detailed property information for this determination. The RHC has

discussed a capital improvement petition process that would allow landlords to recover costs of certain capital improvements without the necessity of providing detailed property records, thereby allowing for an expedited hearing process. The RHC deferred further discussion on a capital improvement petition process while Measure D was pending because Measure D would have mandated an expedited capital improvement petition process. Staff recommends that the RHC consider adopting amendments to Chapter 6 to provide a capital improvement petition process.

ANALYSIS

The Specified Capital Improvement Petition Process has been included in Chapter 6 of the regulations, which addresses upward adjustment petitions. The main features of the draft regulations are summarized below.

A. Summary of Regulations

(a) Authority for Specified Capital Improvement Petition—CSFRA Section 1710(a), allows landlords to file a petition for an upward adjustment to ensure a fair and reasonable rate of return. The CSFRA does not define what is considered a fair and reasonable rate of return. Section 1708 of the CSFRA empowers the RHC to set rents at fair and equitable levels to achieve the purposes of the CSFRA and establish rules and regulations for the administration and enforcement of the CSFRA. The RHC is empowered to determine how a fair and reasonable rate of return is to be achieved. The amendments to Chapter 6 determine that a fair rate of return can be achieved either by the maintenance of net operating income or by the recovery of costs of certain capital improvements, defined in Chapter 6 as Specified Capital Improvements.

(b) Specified Capital Improvements – The amendments to Chapter 6 would introduce an expedited petition process for certain capital improvements, defined as Specified Capital Improvements (See subsection (C)(9) and Appendix B). Specified Capital Improvements are generally major Capital Improvements that significantly extend the useful life of the property or that promote environmental sustainability. Specified Capital Improvements must also meet the definition of Capital Improvement already part of Chapter 6 (previously located at subsection (F) but relocated to subsection (C)(3)). The CSFRA limits the capital improvements that can be considered in upward adjustment petitions to improvements necessary to bring the property into compliance with applicable codes and cannot include costs that could have been avoided by the exercise of reasonable diligence in maintaining the property.

(c) Petition- Landlords petitioning for a Specified Capital Improvement Temporary Upward Adjustment would be required to complete a petition that includes

documentation on the type and cost of Specified Capital Improvement installed. Landlords would also be required to provide limited information regarding the property, primarily the current rent roll, and the date that each tenant initially occupied the rental unit. This information is required because the CSFRA prohibits the consideration of capital improvements that arose prior to the current tenancy (Section 1710(a)(3)(D)).

(d) Hearing Process – Once a Specified Capital Improvement Petition is deemed complete and therefore accepted by the RHC, affected tenants will be provided notice and the opportunity to request a hearing on the petition. Tenants requesting consideration of a hardship must do so when requesting a hearing. If no tenant requests a hearing, a hearing officer will decide on the petition without a hearing. If a tenant requests a hearing, the hearing is to be held within thirty (30) days of the request for a hearing. At the conclusion of the hearing, the hearing officer will issue a decision, which is appealable by either the landlord or the tenant.

(e) Standards for Specified Capital Improvement Temporary Upward Adjustments –

- The cost of Specified Capital Improvements including any interest costs must be amortized in accordance with the amortization schedule attached as Appendix B
- The total amount of the Specified Capital Improvement Temporary Upward Adjustment is limited to 10% of the rent for any unit subject to the Upward Adjustment. If the landlord cannot recover the full cost of the Specified Capital Improvement because of the 10% limitation, the landlord can opt for a longer amortization period.
- Any Specified Capital Improvement Temporary Upward Adjustment is temporary and will expire either at the end of the amortization period or when the tenant vacates the unit. Vacancy decontrol allows property owners to raise rents upon vacancy to recover the cost of any capital improvements.
- The Upward Adjustment can only be allocated to units benefitted by the Specified Capital Improvements and will be allocated pro rata to all benefitted units. If not all units benefitted by the improvement are included in the petition, the hearing officer will allocate the full cost of the Specified Capital Improvement to all benefitted units and impose the Upward Adjustment only on those units covered by the Petition. In allocating the Upward Adjustment, the Hearing Officer may consider the factors previously approved by the RHC for allocation of upward adjustments such as the relative size of units and tenant tenure (See subsection J of Chapter 6).

- The Specified Capital Improvement Temporary Upward Adjustment is not considered part of rent as defined in the CSFRA and is not included when calculating future annual general adjustments.
- Landlords may petition for approval of Specified Capital Improvements that have not been installed yet, but any Upward Adjustment awarded will not be effective until the Specified Capital Improvements are installed and proof of such installation and final cost is provided to the Hearing Officer.

(f) Other Amendments - Included in the amendments to Chapter 6 are amendments to the Consumer Price Index to be used in determining Adjusted Net Operating Income. The CSFRA mandates that the annual general adjustment be determined by the increase in the Consumer Price Index -All Urban Consumers Index. In 2017, when considering the fair return standards, the RHC elected to adopt the Rent of Primary Residence Consumer Price Index for determining Adjusted Net Operating Income. The Rent of Primary Residence only measures one element of the factors that make up cost of living increases, the cost of housing and is based not only on actual rents, but also on homeowners' estimate of the rent that could be received for their home. The index tends to increase at a rate higher than the All Items index since it is measuring the cost of shelter, an inelastic good with limited choice. Since December 2017, when the RHC began accepting petitions, the Rent of Primary Residence Index has increased by 26% while the All Items index has increased by 15%. The cost of providing housing to tenants is composed of a bundle of goods, including costs of services and products. The All Items index measures the increase in these costs more accurately than the rent of primary residence and thus more accurately reflects a landlord's increased costs for providing the housing. Staff is unaware of any jurisdiction that uses a maintenance of net operating income standard for measuring fair return that does not use the CPI-All Items index for purposes of calculating fair return.

Amendments have also been made to Appendix A, the amortization schedule for capital improvements for MNOI Upward Adjustment Petitions to further refine the schedule and include additional items.

FISCAL IMPACT—The inclusion of a capital improvement petition process may increase the number of upward adjustment petitions received by the RHC, resulting in increases in the costs associated with hearing process. The RHC budget for 2020-21 includes \$100,000 for hearing services. Based on the prior volume of petitions, the budget should be adequate to process Specified Capital Improvement petitions. Staff will return to the RHC if incurred expenses exceed budgeted funds for Fiscal Year 2020-21.

PUBLIC NOTICING – Agenda posting.

ATTACHMENTS

1. Draft Amended Chapter 6: Upward Adjustment Regulations
2. Draft Resolution Adopting Amendments to Regulations Chapter 6
Exhibit A - Draft Regulations Chapter 6: Upward Adjustment Regulations
3. Cost-Recovery Mechanisms in Rent Stabilized Jurisdictions